The Next Wave of Growth for Emerging Markets: Small Capitalization Stocks

By Jeffrey D. Braemer, CFA

As an investment destination, the emerging markets have attracted capital over the past decades with their prospects for faster growth than in the developed markets. Arguably the term “emerging markets” arose in 1981 from a desire to define these growing economies that were strengthening further and had established stock markets[1]. From a current investment perspective, one might debate whether these countries have already emerged, hence some prefer the term “developing markets.” It is also worth noting that the next generation of emerging economies—ones that would seem to meet the original definition—are currently identified as the “frontier markets.[2]”

We believe that many of the trends propelling the emerging markets, such as spending on consumption and infrastructure, foretell their ongoing growth advantage over developed markets. At the same time, the capital markets in those countries have expanded and stratified, so that we see the greatest future growth in emerging markets arising from their small capitalization stocks, an area apparently well-suited for active management.

The Growing Consumer Class in Emerging Markets

In the emerging markets, as in developed markets, small capitalization companies tend to be more locally focused than large capitalization companies. In addition to buffering them from global macroeconomic effects, smaller companies that are more specialized can adapt quicker to changes and would benefit more from positive trends in their local markets. In the emerging markets, one of those positive trends is demographic change.

For example, the emerging markets have seen burgeoning population growth of their middle classes, with various forecasts for an ongoing population surge[3]. In terms of the numbers, consider the growth in the two most populous emerging markets countries, China and India (Table 1):

Table 1: Expected Growth for the Middle Class in Selected Countries

Country	2013	2020 (est.)	2030 (est.)
China	150 million	500 million	1,000 million
India	50 million	200 million	475 million

Source: Ernst & Young

[1] Sample citation at http://knowledge.wharton.upenn.edu/article/when-are-emerging-markets-no-longer-emerging/

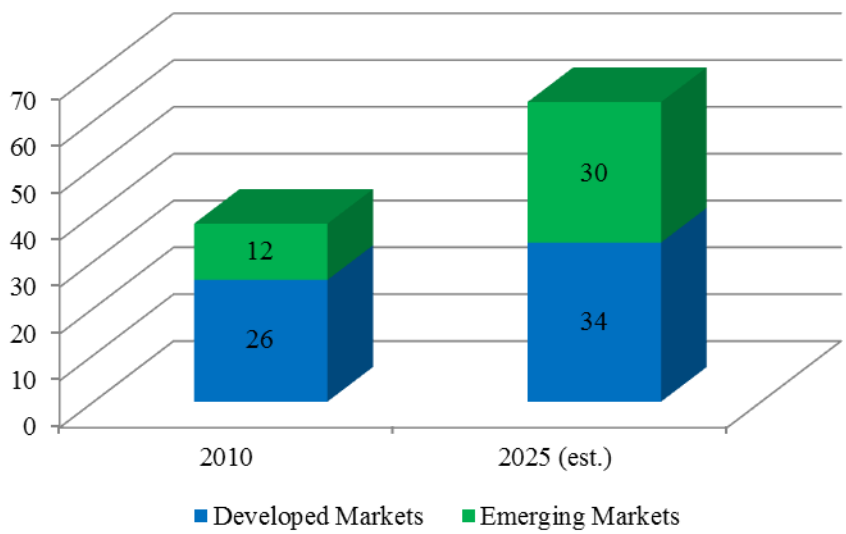
[2] While some sources use “emerging” and “developing” interchangeably, this paper will follow the naming convention of developed, emerging, and frontier markets, whose country memberships are defined by the index data provider MSCI https://www.msci.com/market-cap-weighted-indexes

[3] Ernst & Young 2013.

Varying country-by-country, the generally accepted definition for the middle class is an income level that allows emerging markets consumers to purchase motor transport, televisions, and white goods (such as refrigerators and washing machines)—along with services for health care, banking, leisure, and education. Those goods and services have been the staples of middle class life since that population segment grew after World War II in the developed North American, European, and Asian countries. Thus increases in middle class populations have led to changing consumption patterns.

In other words, the "consuming class" has become a major economic force in emerging markets and its influence should increase over time. Over the last 20 years, the consuming class in emerging markets doubled to its current level of 2.4 billion people. By 2025 that population is expected to nearly double again and become 4.2 billion emerging markets consumers out of an estimated global population of 7.9 billion (McKinsey 2012), so more than half of the world's population will be the consumer class in emerging markets. Similar growth is expected in dollar terms (Chart 1):

Chart 1: World Consumption ($ trillion)[4]



Source: McKinsey

Exploring the underlying consumer data in the emerging markets, we uncover various areas of faster growth than in developed markets. In particular, household consumption levels have been strong with notable amounts of savings that could serve effectively as reserve funds for later spending (Charts 2-5):

[4] All monetary value comparisons are based on U.S. dollars at purchasing power parity for other currencies.

Chart 2: Household Consumption ($ billions)

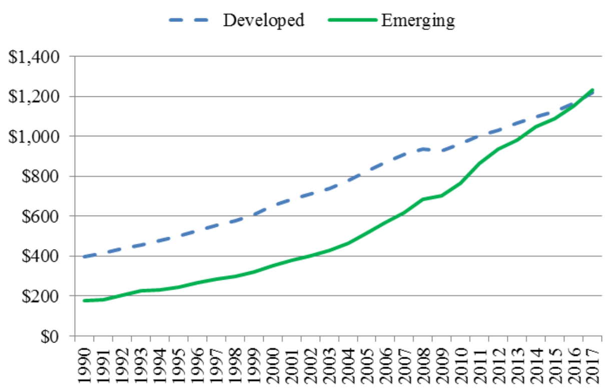


Chart 3: Household Savings as a Percentage of GDP

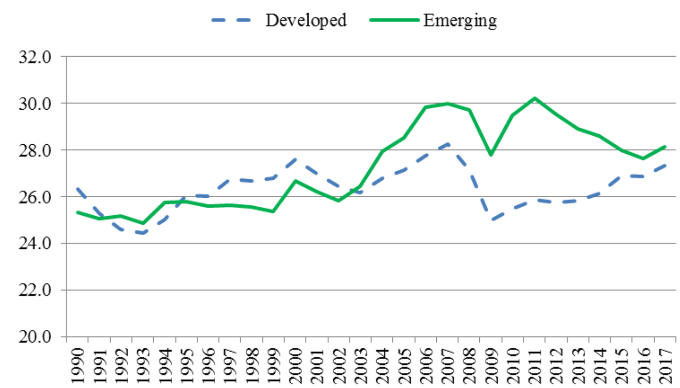


Chart 4: Health Care Spending per 100,000 People (Arithmetic Scale)

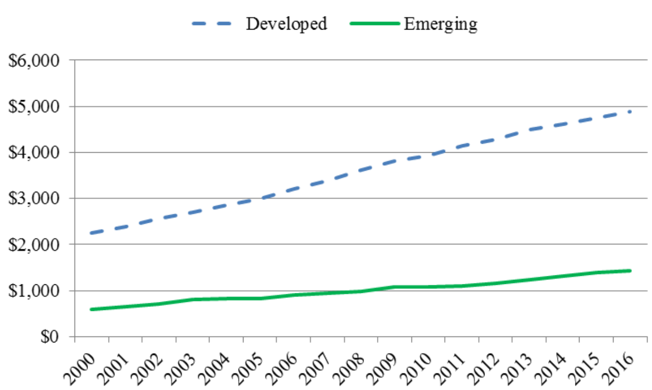
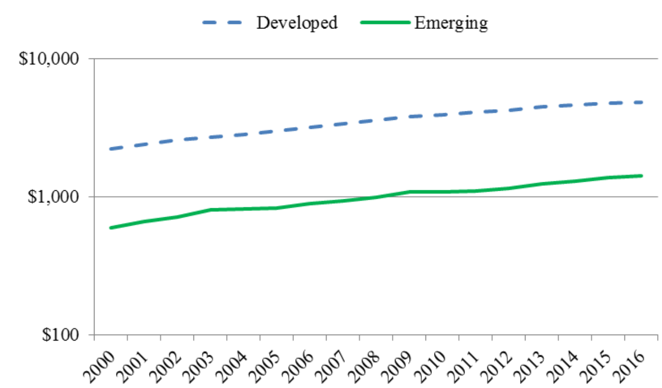


Chart 5: Health Care Spending per 100,000 People (Log Scale)



Source: World Bank

(Comparisons of Developed and Emerging are based on country averages within each category. Monetary value comparisons are based on U.S. dollars at purchasing power parity for other currencies)

Note that for the most recent year of available data, household consumption in emerging markets was higher than in developed markets for the first time. When considering household savings—which could fuel future consumption spending—emerging markets continues to exceed developed markets.

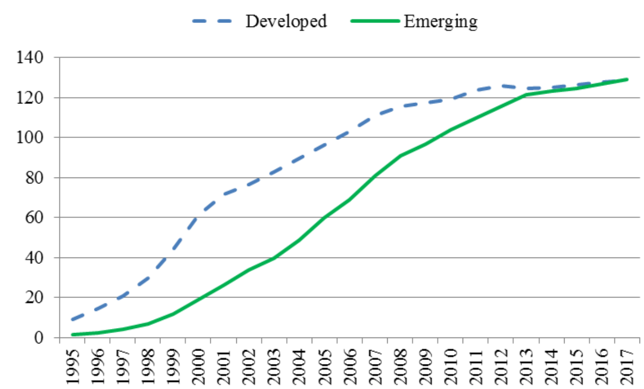
One common global area of significant spending in recent years has been on health care. Because the higher costs for health care in developed markets mask the similar spending growth rates in emerging markets when using an arithmetic scale, a log scale reveals that similarity (i.e., a scale that treats a 10x change the same, whether it was from 100 to 1,000 or from 1,000 to 10,000).

Infrastructure Spending and Development

Aside from the growing consumer needs, emerging markets have a growing and prodigious appetite for new infrastructure. As with the case for consumers, we believe that the locally-focused, small capitalization companies should reap significant benefits from that internal development. Areas that have demonstrated that growth include telecommunications—such as internet access, power consumption, and shipping.

Related to internet usage, while its penetration in emerging markets has not yet achieved the same level as in developed markets, more than half of all internet users are in the emerging markets (McKinsey 2012). Also of note is that mobile access has grown far faster in emerging markets than in developed markets, in part because its communications infrastructure focused on wireless instead of the older—and more established for developed markets—fixed-line technology (Chart 6):

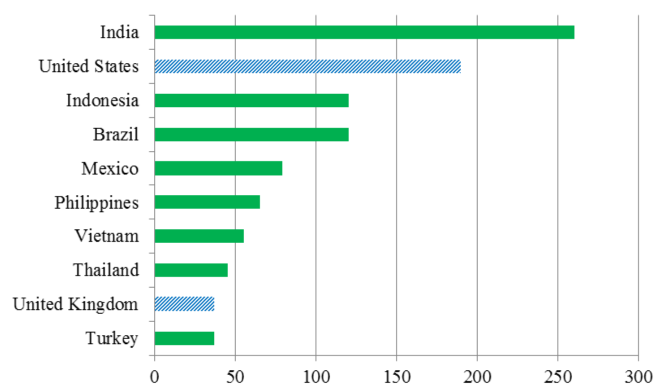
Chart 6: Mobile Phone Subscriptions per 100 people



Source: World Bank

With that development of wireless communications infrastructure, it should not be surprising that most of the countries with the largest number of Facebook users are in the emerging markets (Chart 7):

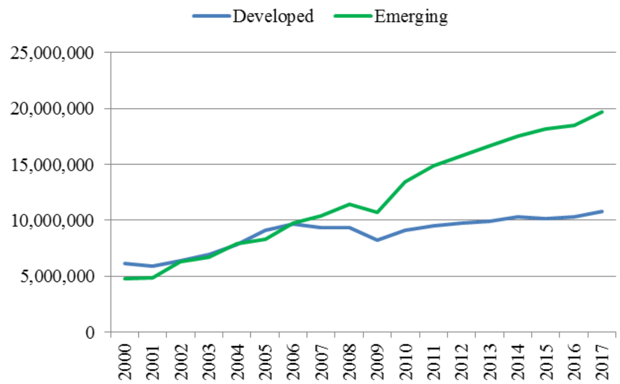
Chart 7: Leading Countries for Number of Facebook users (in millions)
Emerging - Developed



Source: Statista (Digital Market Outlook)

Over the last 20 years, electric power consumption per capita in the emerging markets has increased by over 50% on average compared with an increase of 6% for the developed markets (World Bank). That growth was a function of both demand—from increased industrial and consumer needs—and supply—from building new power plants. For example, to boost its supply of electricity Pakistan's government joined with China to build $21 billion of energy projects (Shah 2016). Part of that arrangement required improvements to Pakistan's port structure so that it could import natural gas and coal for the new plants. Such port development has been common across emerging markets for both imports and exports. As a result, the container port traffic has grown significantly and faster than in developed markets (Chart 8):

Chart 8: Container Port Traffic (20-foot equivalent units)

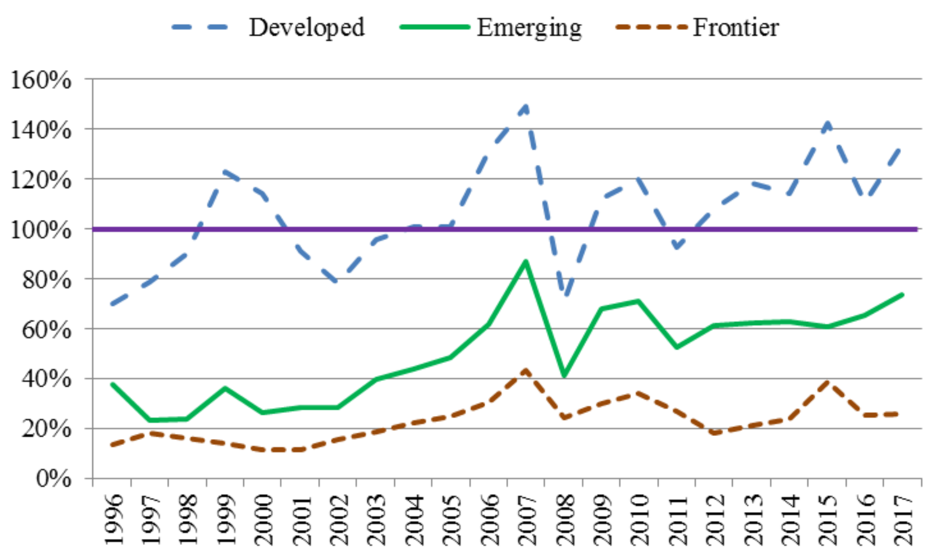


Source: World Bank

Capital Market Development

At a high level, when we initially evaluate the investment opportunities in emerging markets, we consider their "equitization ratios." Defined as a country's total stock market capitalization divided by its gross domestic product, the equitization ratio measures whether a country's economic activity has been fully reflected in its stock market (a level of 100%), or whether there is room for the capital markets to grow further (less than 100%). Both emerging and frontier markets have significant growth potential based on their equitization ratios, especially compared with the developed markets (Chart 9):

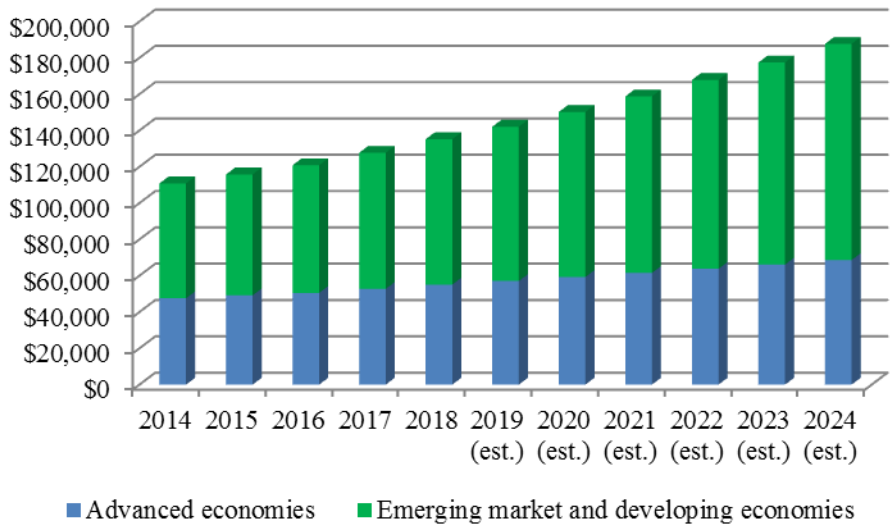
Chart 9: Equitization Ratio of Country Groups



Source: GDP and Market Capitalization data from the World Bank

We expect that equitization ratios for the emerging markets will become even more attractive as the denominator of the ratio (GDP) continues to increase for them. Presently, the emerging markets collectively account for 60% of global GDP, and that share is expected to climb over time. Given that total global GDP is also expected to expand, the dollar value of emerging markets should increase dramatically (Chart 10):

Chart 10: Current and Estimated Share of Global GDP[5]



Source: International Monetary Fund's IMF Data Mapper, based on the World Economic Outlook (April 2019)

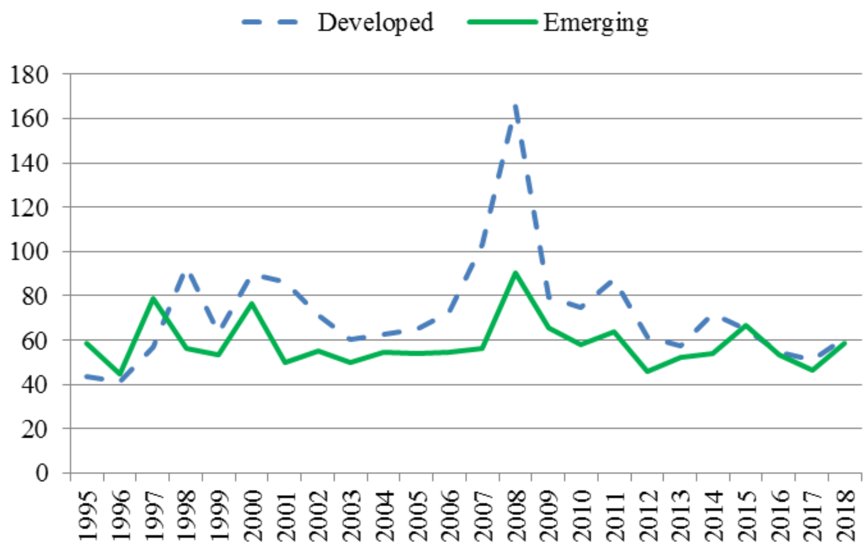
We also believe that because of their domestic focus, the small capitalization companies in the emerging markets will benefit disproportionately from the continued growth of those countries.

The emerging markets have also become more investable over time in terms of corporate governance. The International Accounting Standards Board (IASB) established a global set of financial reporting standards in 2001, known as the International Financial Reporting Standards (IFRS). Since then, nearly all of the developed, emerging, and frontier markets have made IFRS a requirement for their domestic publicly accountable entities (for those that do not require it, many at least permit companies to report in accordance with IFRS). This provides investors with a common reporting framework for evaluating companies in these markets. The few notable exceptions—the United States and China—have their own accounting standards though have expressed support for IFRS (IFRS 2019).

Once an investor evaluates an emerging markets company, market liquidity needs to be assessed. Aside from 2008's financial crisis in developed markets, stocks have been trading in emerging markets at a level similar to development markets for some time (Chart 11):

[5] Based on billions of U.S. dollars at purchasing power parity for other currencies

Chart 11: Turnover Ratio of Domestic Shares (%)[6]



Source: World Bank

As the capital markets developed in these emerging economies, the number of potential investment opportunities (i.e., publicly traded stocks) multiplied. With those increases, we believe that many emerging markets have stratified in terms of company sizes. To us, that makes separately evaluating each country's small capitalization stocks from the large capitalization stocks just as appropriate here as we do in the developed markets.

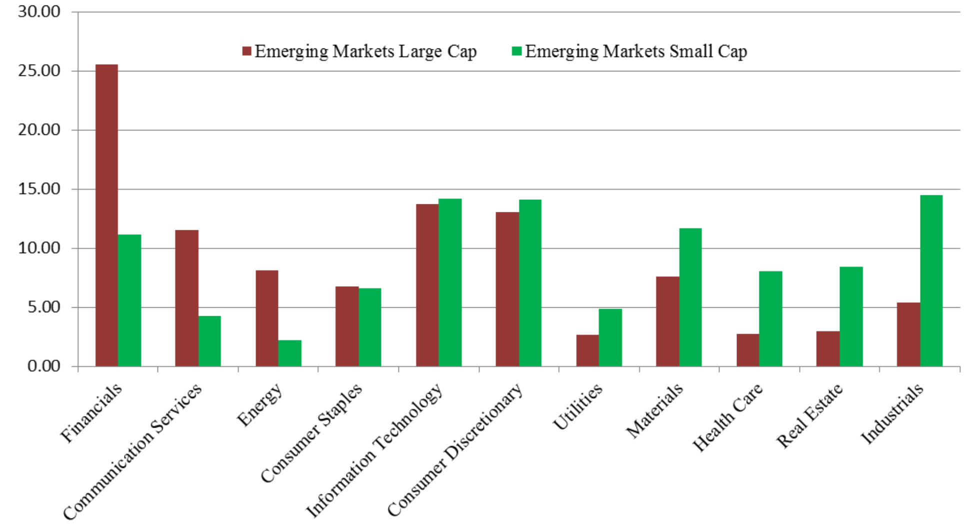
The Attractiveness of Small Capitalization in Emerging Markets

We believe that the small capitalization companies in emerging markets are the ones that are best positioned to benefit from the growing influence of the consuming class and increased infrastructure activity. Evidence comes from comparing the universes of small and large capitalization companies in emerging markets, using the MSCI Emerging Markets and MSCI Emerging Markets Small Cap indexes as proxies for each[7]. Based on the Global Industry Classification Standard (GICS) definitions for economic sectors, the small capitalization universe has greater exposures to Industrial, Real Estate, Health Care, Utilities, and Consumer Discretionary companies—all of which tend to be locally focused (Chart 12):

[6] Annual value of domestic shares traded divided by their market capitalization.

[7] For other comparisons with large capitalization U.S. companies, small capitalization U.S. companies, large capitalization non-U.S. developed market companies, and small capitalization non-U.S. developed market companies, some tables or charts include the Russell 1000, Russell 2000, MSCI EAFE, or MSCI EAFE Small Cap indexes, respectively.

Chart 12: GICS Sector Exposures for Emerging Markets Small Cap vs. Large Cap (%)



Source: MSCI Index Factsheets for May 31, 2019

In addition, note that the sector weights within the indexes above are more evenly distributed in the small capitalization universe than among large capitalizations. That same greater degree of dispersion and breadth within the emerging markets small capitalization universe can also be seen with respect to the five largest country weights and collective weight for the 10 largest stocks. In both instances, there is less dominance by a single country or by a small number of securities within small capitalizations (Table 2):

Table 2: Top Country and Position Weights (%)

	Emerging Markets Large Cap	**Emerging Markets Small Cap**
Top Five Countries		
China	31.1	11.7
South Korea	12.1	16.0
Taiwan	11.0	18.6
India	9.5	16.1
Brazil	7.6	7.6
Top 10 Index Members	23.0	3.4

Source: MSCI Index Factsheets for May 31, 2019

Revisiting the earlier discussion on the potential benefits accruing to companies that focus on the growth in their home countries, we compare the portions of revenues from domestic sources for the various equity markets, which favors small capitalizations (Table 3):

Table 3: Percent of Sales from Home Country as of March 31, 2019

Russell 1000	63.3%
Russell 2000	81.2%
MSCI EAFE	32.4%
MSCI EAFE Small Cap	58.1%
MSCI Emerging Markets Small Cap	**72.0%**

Source: FactSet

Another issue to review when evaluating the growth potential of emerging markets would be the degree the prevailing valuations reflect those expectations. One method would be comparing the ratio of current market prices to expected earnings, with the expected growth rates for those earnings. In other words, divide the Price/Earnings ratio by the Growth rate, which is often referred to as the “PEG Ratio.” With a PEG Ratio, typically a value of 1.0x indicates the current valuation completely reflects the projected earnings growth, a value greater than 1.0x signifies valuations are expensive, and a value less than 1.0x suggests that valuations are attractive (Table 4):

Table 4: PEG Ratios as of May 31, 2019

Russell 1000	1.63x
Russell 2000	1.49x
MSCI EAFE	1.58x
MSCI EAFE Small Cap	1.20x
MSCI Emerging Markets Small Cap	**0.74x**

Source: FactSet

Once investors recognize the attractiveness of emerging markets small capitalization stocks, the next consideration would be whether a passive or active approach would best capture those opportunities. To answer that, investors should review what considerations might make emerging markets small capitalization an area better suited for active managers.

One measure would be the coverage by sell-side analysts—professional analysts employed by investment banks, brokerage firms, and research boutiques that provide investment reports to institutional and retail clients. Typically, emerging markets small capitalization stocks have been underfollowed by these analysts in comparison to those in developed markets, and have a large universe of names from which to choose (Table 5):

Table 5: Analyst Coverage Comparisons as of March 31, 2019

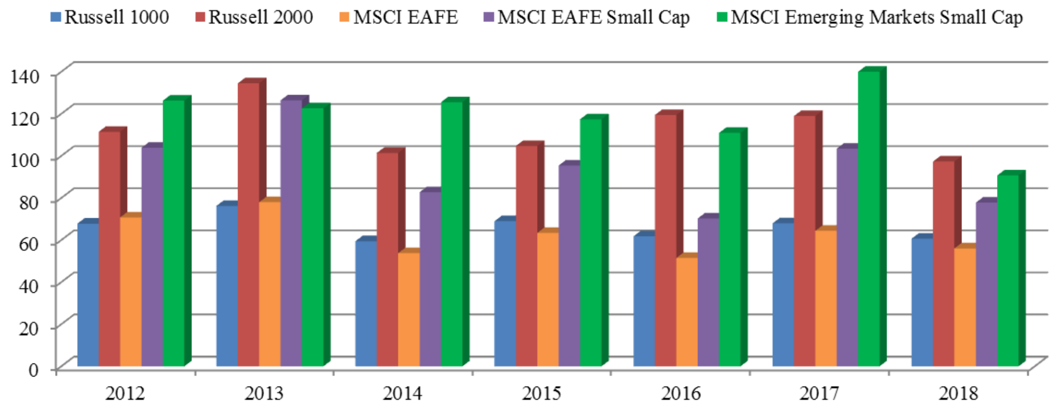
	Number of Stocks	Average Number of Analysts per Stock	Percentage of Stocks with Single or No Analyst Coverage
Russell 1000	970	16	1.2%
Russell 2000	1,884	6	9.7%
MSCI EAFE	918	14	2.0%
MSCI EAFE Small Cap	2,241	5	24.0%
MSCI Emerging Markets Small Cap	**1,374**	**5**	**27.9%**

Source: FactSet

We do not believe the lack of coverage for emerging markets small capitalization companies was because those companies were unreceptive to outside investors. In our investment team’s many years of analyzing companies and meeting with their managements, we have found them to be very welcoming to investors from developed markets. Some have told us that having institutional investors from outside their country made them feel as if they had received a stamp of approval and finally arrived on the global capital markets stage.

Another gauge would be the breadth of potential returns. Greater dispersion, calculated as the difference between the average returns of the top 20% (or quintile) and bottom 20% of performance, would indicate that active managers have a wider range of opportunities from which to choose. Typically, emerging markets small capitalization stocks have seen a larger range (Chart 13):

Chart 13: Dispersion between Top and Bottom Performance Quintiles



Source: FactSet

Less quantifiable, but no less meaningful to investors, would be the nature of indexes in general. Weightings for countries, sectors and even individual stocks are determined by their relative size[8], which is a function of the past growth for each. In other words, the index represents where the growth in emerging markets small capitalization was in the past, not necessarily where it might be in the future. To the extent that this segment of emerging markets has less coverage (Table 5) and wider outcomes (Chart 13), a more active approach would seem beneficial to investors.

Conclusion

Emerging markets small capitalization stocks have differentiated themselves from their large capitalization brethren as these countries have developed. Ongoing demographic shifts in emerging markets favor the types of companies that dominate the emerging markets small capitalization universe, and could provide significant future runways for growth. What remains underdeveloped was the attention and activity from outside investors, which we believe creates significant opportunities for those that are willing to commit the efforts to build active investment portfolios for emerging markets small capitalization stocks.

[8] See for example https://www.msci.com/index-methodology.

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TimesSquare Capital Management, LLC
7 Times Square, 42nd Floor, New York, NY 10036